

EVOLUTION, STRUCTURE AND PERFORMANCE OF KENYA'S FINANCIAL SYSTEM

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1. Introduction

By definition, a financial system is a sector engaged in the creation of the types of assets that others wish to hold from the kind of financial liabilities that debtors are willing to incur. Seen in this way, a financial sector does occupy a vital role in an economy because any variations in the composition and size of financial institutions' assets and liabilities, as well as changes in the manner in which they offer services will induce other sectors not only to alter their portfolio allocation decisions but also to change their decisions to save and invest. Thus, While a financial sector is a complex of markets for financial assets and services, the sector is distinctive in the way its markets, prices, institutions, and policies affect other sectors of the economy.

In the majority of cases a financial system comprises two sectors, namely the banking and non-banking sectors. The banking sector consists of the central bank and the commercial banks. The non-banking financial sector includes other financial institutions, insurance companies, pension funds and other non-monetary financial institutions. In this analysis, a distinction is made between two categories of a financial system. First, there is the monetary system group, which can be termed as the creator of an economy's means of payment. This group includes the banking system and the non-bank financial institutions. The first category plays a significant role in determining changes in aggregate expenditure and economic activity. The first group can expand or contract their total assets and liabilities not only in response to their customers' decisions but also on their own initiative, thereby setting in motion an adjustment process among other transactors. The second group, the non-monetary financial institutions, cannot create money. Good examples of this group are the pension and the social security funds.

A financial system performs two major roles in an economy, in acting as an intermediary in the process of intersector finance. Firstly, it encourages the saving habit by providing security for the money generated and by offering a return for the money saved. Secondly, a financial system finds eligible borrowers for the funds deposited with them. In this way the funds are employed in maintaining the current level of production or in increasing investment in new production processes. Indeed, a financial system can be seen as a facilitation mechanism for lenders to save in financial assets which give them the maximum rate of return. Likewise, the financial sector enables borrowers to get loans at

* The views expressed in this paper are authors' and do not necessarily reflect the opinion of the Central Bank of Kenya.

minimum cost.

When net lenders and borrowers are accommodated, this makes a significant difference to the way the economic system overall works. For instance, part of the savings that are not directly invested in real assets may take the form of financial assets. Savers do not decide directly to finance others' deficits and sectors with surpluses do not decide directly to finance sectors with deficits. However, these savers or sectors with surpluses decide to hold financial assets to suit their preferences for liquidity and yield. A financial sector ensures that the asset preferences of those with surpluses can be appropriately matched with the types of liabilities that those with deficits are able and willing to incur, partly through changes in relative interest rates and security prices and partly through the operations of the entire system.

Borrowers could, of course, approach savers directly for investment funds but at least three factors make this difficult. While borrowers tend to be few and often need large sums of money in one single arrangement, savers tend to be many and in most cases involving small sums of money. Therefore, it would be very difficult for an investor to find a single saver to satisfy his financial need through a direct approach, and the administrative cost of doing so could be very heavy. Furthermore, the savers tend to prefer the security offered for their savings by a financial system instead of repayment guarantees of borrowers which may have lower creditworthiness. This is so because savers are confident that financial intermediaries will make available their savings when need arises. This also leads to the third point: that many savers are unwilling to tie-up their funds for long periods while many borrowers need long-term loans to finance their projects. Financial institutions are effectively able to transfer the short-term needs of savers into the long-term requirements of borrowers.

A financial system also plays an important intermediating role in providing the linkage between the domestic economy and the international economy by way of facilitating an exchange of international foreign exchange surpluses. For example, cases where developing countries are not able to generate sufficient foreign exchange reserves to meet their import requirements to cover the shortfalls, foreign loan facilities are syndicated through banks. The linkage provided by a financial system between domestic and foreign banks enables businessmen in one country to obtain goods from suppliers abroad without need for interpersonal contacts or immediate settlement.

In what follows, an attempt is made to analyse the development of one of Africa's financial systems. Section 2 offers a brief review of the historical development of the financial system of Kenya. An assessment of the relative performance of selected groups of Kenya's financial institutions is provided in Section 3. Section 4 discusses deve-

lopments in financial intermediation, asset portfolio composition and liquidity. Section 5 presents a summary of findings and remarks on future prospects for Kenya.

2. Kenya's Financial System

In Kenya, the financial system is organized along fairly conventional lines. The system is made up of the Central Bank, the commercial banks and the non-bank financial institutions licenced under the Banking Act, building societies, development finance companies funded mainly by government and external development agencies, a Post Office Savings Bank, a National Social Security Fund, insurance companies, pension funds, and a stock exchange.

Both the history of banking business in Kenya and the initial development of banking institutions are closely linked to the commercial banking connections between India and East Africa towards the end of the 19th century¹. The National Bank of India (which was subsequently incorporated by the National and Grindlays International Bank) was the first (foreign) bank to do business in Kenya. Its first branch was opened in Mombasa in 1896. This was followed by the Standard Bank of South Africa in 1910 and the National Bank of South Africa in 1916.

Later, in 1926, the National Bank of South Africa emerged with the Colonial Bank and the Anglo-Egyptian Bank to form Barclays Bank (Dominion, Colonial and Overseas - D.C.O.). Two of these three banks were branches of British banks, and they dominated the banking system until 1950's when other foreign banks joined the banking industry.

These three banks have evolved and developed over time so that the National Bank of India (formerly incorporated as National and Grindlays International Bank) split in 1970 to become the Kenya Commercial Bank² and Grindlays International Bank. The Standard Bank of South Africa became Standard Bank and a member of the Standard Chartered Group. The National Bank of South Africa became Barclays Bank, D.C.O. By 1965 these three foreign banks accounted for 80 per cent of the banking system's

1. Frediani, L. "The Liquidity Policy of Deposit Banks in Kenya", in *The Credit Markets of Africa*, Dell'Amore, G. Milan, 1975.

2. Kenya Commercial Bank was formed in 1970 from the retail banking business of National and Grindlays Bank. The Government acquired 60 per cent of the capital and 40 per cent of the capital -as retained by the former bank. In 1976 Kenya Commercial Bank became fully-owned by the Government.

total deposits with a combined network of 177 branches. Other commercial banks that joined these early foreign banks were Algemene Bank Nederland, N.V. (1951), Bank of India (1953), Bank of Baroda (1953), Habib Bank Overseas (1956) and Commercial Bank of Africa (1958).

Following the attainment of Kenya's political independence in 1963, several locally owned banks were established, namely, the Central Bank of Kenya (1966), the Co-operative Bank of Kenya (1968) and the National Bank of Kenya (1968). The number of commercial banks continued to expand with most of the growth occurring in the period 1980-1986, when additional 9 commercial banks were licenced. In 1986 commercial banks in Kenya numbered 24 and of the 24, 15 were foreign banks. Table 1 gives the number of commercial banks and their branches as at December 1986.

Both the Standard Bank and Barclays Bank have now converted their operations from branches to locally incorporated subsidiaries, and Barclays has sold some of its shares on the local market. Sales of shares have also been foreshadowed for the Standard Bank and the two Government owned banks — the Kenya Commercial Bank, and the National Bank of Kenya.

The banking business performed by non-bank financial institutions started in the 1940's — almost forty years after the first commercial bank was established. The hire-purchase companies were the first group of non-bank financial institutions to start banking business, specializing in hire-purchase finance. The first hire-purchase company was the Diamond Trust Company (1946) established to serve the Ismaili community. This was followed by Credit Finance Corporation (1955) and National Industrial Credit (1959) affiliated to Barclays Bank. These three non-bank financial institutions accounted for 18 per cent of the non-bank financial institutions' deposits in 1973.

The number of non-bank financial institutions increased rather rapidly in the period between 1979 and 1986. Since the early 1980's many non-bank financial institutions have emerged to do some types of general banking business, such as mortgage lending, hire-purchase, bridging finance, loans for the construction of buildings, bill discounting, trade finance, etc. By 1982, 55 per cent of the non-bank financial institutions' business went to these general business institutions. Table 2 gives the number of non-bank financial institutions and their branches as at December 1986.

The Building Societies, which specialize in mortgage lending for the purpose of construction of residential houses (and other buildings) as well as mobilizing deposits from households, started to operate in Kenya in 1949. Savings and Loans (Kenya) was the first to go into the activity of mortgage lending in 1949, originally associated with the

Table 1:

COMMERCIAL BANKS AND THEIR BRANCH NETWORK

Name of Bank	Full Branches	Sub Branches	Agencies/ Mobile Units	Total
1. Algemene Bank Nederland	2	—	—	2
2. Bank of Baroda	6	—	—	6
3. Bank of Credit and Commerce International	7	—	—	7
4. Bank of India	2	—	—	2
5. Bank of Oman	1	—	—	1
6. Banque Indosuez	2	—	—	2
7. Barclays Bank of Kenya	41	7	34	82
8. Biashara Bank	2	—	—	2
9. Citibank	1	—	—	1
10. Commercial Bank of Africa	3	4	—	7
11. Continental Bank of Kenya	3	—	—	3
12. Cooperative Bank	6	2	1	9
13. First American Bank of Kenya	1	—	—	1
14. Grindlays Bank International (K)	2	—	—	2
15. Habib Bank A.G. Zurich	2	—	—	2
16. Habib Bank	4	—	—	4
17. Kenya Commercial Bank	59	43	126	228
18. Middle East Bank	2	—	—	2
19. National Bank of Kenya	10	3	2	15
20. Pan African Bank	7	—	—	7
21. Standard Chartered Bank	37	1	—	38
22. Trade Bank	1	—	—	1
23. Trans-National Bank	1	—	—	1
24. Union Bank of Kenya	3	—	—	3
Total	205	60	163	428

Source: Central Bank of Kenya: Annual Reports

Pearl Assurance Company and later becoming a subsidiary of Kenya Commercial Bank. Other mortgage lending institutions that followed are East African Building Society (1959), Akiba Loans and Finance Company (1972), Home Savings and Mortgages (1982), all of which have no connection with any commercial bank. Table 3 gives the names of building societies licenced under the Building Societies Act.

In December 1986, financial institutions other than commercial banks consisted of 52 non-bank financial institutions with a network of 92 branches, 32 building societies, 40 insurance companies, 10 development finance companies, 64 hire-purchase companies,

Table 2:
FINANCIAL INSTITUTIONS AND THEIR BRANCH NETWORK

Name of Financial Institution	Branches in Nairobi	Branches in Mombasa	Other Towns	Total
1. Akiba Loans & Finance	1	—	—	1
2. Arab Africa Finance	1	—	—	1
3. Ari Credit and Finance	1	—	—	1
4. Bank of India Finance (Kenya)	1	—	—	1
5. Business Finance Company	2	—	—	2
6. Bank of Credit and Commerce International	1	—	—	1
7. Capital Finance	1	—	—	1
8. Central Finance (K)	1	—	1	2
9. City Finance	1	—	—	1
10. Commercial Bank of Africa Finance	1	—	—	1
11. Consolidated Finance	1	—	—	1
12. Continental Credit Finance	1	—	1	2
13. Cooperative Finance	—	—	—	—
14. Credit Finance Corporation	2	1	—	3
15. Credit Kenya	1	—	—	1
16. Devna Finance Company	—	—	1	1
17. Diamond Trust of Kenya	2	1	1	4
18. Equatorial Finance Company	1	—	—	1
19. Estate Finance Company of Kenya	1	1	—	2
20. Finance Institution of Africa	1	—	—	1
21. First Chicago Kenya	1	—	—	1
22. Grindlays International Finance (K)	1	—	—	1
23. Habib Zurich Finance (K)	1	—	—	1
24. Home Savings and Mortgages	2	—	1	3
25. Housing Finance Company of Kenya	1	1	2	4
26. Industrial Development Bank	1	—	—	1
27. Inter African Credit Finance	1	—	—	1
28. International Finance (K)	1	—	—	1
29. Investments and Mortgages	1	—	—	1
30. Jimba Credit Corporation	1	1	—	2
31. Kenya Commercial Finance Company	1	1	1	3
32. Kenya Finance Corporation	1	1	1	3
33. Kenya National Capital Corporation	2	1	2	5
34. Kenya Savings and Mortgages	1	—	—	1
35. Lima Finance	1	—	—	2
36. Mercantile Finance Company	1	—	—	1
37. Middle Africa Finance Company	1	—	—	1
38. Mombasa Savings and Finance	1	1	—	2
39. Nairobi Finance Corporation	—	—	—	—
40. National Industrial Credit	1	—	—	1
41. Nationwide Finance Company	2	—	2	4
42. Pan African Credit and Finance	1	1	—	2
43. Prudential Finance	1	—	—	1
44. Rural Urban Credit Finance	—	—	—	—
45. Savings and Loans (K)	1	1	3	5
46. Southern Credit Finance	1	1	—	2
47. Standard Chartered Acceptances	1	1	1	3
48. Thabiti Finance Company	2	—	2	4
49. Trans-National Finance Company	1	1	2	4
50. Union Credit	1	—	—	1
51. United Trustee Finance	1	—	1	2
52. Zender Finance Company	1	—	—	1
Totale	55	13	24	92

Source: Central Bank of Kenya: Annual Reports

Table 3

BUILDING SOCIETIES, LICENCED UNDER BUILDING SOCIETIES ACT

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- | | |
|-----|----------------------------------|
| 1. | Agrarian Building Society |
| 2. | Alliance Building Society |
| 3. | Budget Building Society |
| 4. | Busara Building Society |
| 5. | Central Building Society |
| 6. | Citizen Building Society |
| 7. | Commonwealth Building Society |
| 8. | Cosmopolitan Building Society |
| 9. | Country Building Society |
| 10. | East African Building Society |
| 11. | Equator Building Society |
| 12. | Equity Building Society |
| 13. | Estate Building Society |
| 14. | Executive Building Society |
| 15. | Family Finance Building Society |
| 16. | Family Shelter Building Society |
| 17. | Gatanga Building Society |
| 18. | Home Loans Building Society |
| 19. | Kentanda Mutual Building Society |
| 20. | Kenya Wide Building Society |
| 21. | Kiambere Building Society |
| 22. | Mariga Building Society |
| 23. | Nationwide Building Society |
| 24. | Pioneer Building Society |
| 25. | Prudential Building Society |
| 26. | Pan African Building Society |
| 27. | Regional Loans Building Society |
| 28. | Shelter Building Society |
| 29. | Sunrise Building Society |
| 30. | Tropical Building Society |
| 31. | Trust Building Society |
| 32. | United Kenya Building Society |
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Source: Central Bank of Kenya

the Post Office Savings Bank, the National Social Security Fund, over 900 savings and credit cooperative societies, numerous private pension funds, and a stock exchange.

3. Performance of Kenya's Financial System

The growth of assets is an important aspect of Kenya's financial system which can be used as a yardstick to measure its performance. Total assets of the financial system

increased from shs 2,655m in 1968 to shs 76,260m in 1986 with most of the growth in the current value of total assets occurring in the 1980's. While commercial banks have remained dominant in terms of total assets³, their share in total assets of the financial system declined from 57.5 per cent in 1970 to 46.6 per cent in 1986. In contrast the share of non-bank financial institutions increased sharply from 7.9 per cent in 1970 to 29.0 per cent in 1986. The relatively more rapid growth in assets of the non-bank financial institutions reflect, in part, the rapid increase in the number of non-bank financial institutions from 8 in 1968 to 52 in 1986. Table 4 gives the breakdown and growth of the assets of Kenya's financial system from 1968 to 1986.

In terms of total public deposits mobilized and credit extension, commercial banks are the most dominant in Kenya. In December 1986, the 24 commercial banks had total credit equivalent to shs 29,765m and approximately shs 29,396m of private deposits. For comparison, total credit and private savings placed with non-bank financial institutions other than insurance companies and building societies amounted to shs 16,106m and shs 16,116m respectively. Table 5 provides a breakdown of credit and deposits of the financial system. Barclays Bank, Kenya Commercial Bank and Standard Chartered Bank, the three largest commercial banks, had a market share in terms of private deposits and lending of about 60 and 54 per cent respectively in December 1986. About 49 per cent of deposits at commercial banks were time deposits, and 51 per cent were demand deposits or deposits which do not earn interest.

In December 1976, the deposit liabilities of non-bank financial institutions licenced under the Banking Act constituted only 18 per cent of total banking system liabilities. By the end of 1986, the proportion had reached 41 per cent. At the same time, assets of non-bank financial institutions which were 16 per cent of total assets of the financial system in 1976 reached 29 per cent by 1986, while private deposits held by non-bank financial institutions rose from shs 1,430m in 1976 to shs 16,116m in 1986. For comparison private deposits held by commercial banks rose from shs 6,860m in 1976 to shs 29,396m in 1986. This shows a more rapid growth in the deposits with non-bank financial institutions relative to that of commercial banks.

The rapid growth in the deposits with non-bank financial institutions implies that in addition to increasing competition in the market for deposits, the non-bank financial institutions have become an important vehicle for domestic resources mobilization.

3. With respect to size, in terms of total assets, 30 of the 40 largest banking institutions are commercial banks excluding the Central Bank of Kenya.

Table 4
BREAKDOWN OF ASSETS OF THE FINANCIAL SYSTEM

	(shs m)										
	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
Total Assets	2655	3591	5018	5269	6093	7666	8895	10115	12551	18861	20529
Commercial Banks	1801	2263	2885	3170	3577	4616	5365	5994	7489	10724	12357
Non-banks	—	—	395	644	793	1008	1139	1643	1944	2776	3775
Central Bank	854	1329	1738	1455	1723	2042	2391	2478	3118	5360	4397
Liquid Assets of Commercial Banks	—	—	—	563	717	1048	872	1006	1687	2894	2515
Liquid Assets of Non-banks	—	—	—	—	—	—	155	324	237	398	686
				1979	1980	1981	1982	1983	1984	1985	1986
Total Assets				25968	28692	33150	42034	46469	52283	63769	76260
Commercial Banks				14622	15572	17315	20360	21287	24682	27130	35496
Non-banks				4935	6389	7801	10256	12536	17327	19934	22127
Central Bank				6411	6731	8034	11418	12645	13542	16707	18637
Liquid Assets of Commercial Banks				2938	2205	2760	4272	3408	4655	4519	8267
Liquid Assets of Non-banks				1116	1198	1158	1719	2926	4554	4344	6080

Source: Central Bank of Kenya

A significant portion of bank credit is extended on an overdraft basis, though some medium-term loans are also provided by commercial banks, particularly the larger ones. Most of the loans provided by commercial banks are for trade financing and foreign exchange transactions. Approximately 16-20 per cent of commercial banks loans are made to the manufacturing sector, mainly for working capital purposes. Loans to the service sector also account for a significant portion of total bank credit extension. Table 6 gives the distribution of commercial banks credit to various sectors of the economy.

The non-bank financial institutions have also been an important source of credit to the key sectors of the economy and for specialised purposes. At the end of 1986 the non-bank financial institutions had loans outstanding of shs 1,241m to agriculture alone and shs 1,659m to manufacturing compared with shs 43m and shs 36m respectively in 1973. The non-bank financial institutions' contribution to the development of housing has also been substantial. Moreover, a great number of these institutions have specialized in provision of mortgages for houses and housing development. Table 7 provides

Table 5
BREAKDOWN OF MAIN FINANCIAL INSTRUMENTS

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
1. Total credit by the Financial System	1433	1423	1610	2582	3098	3857	5088	6022	7362	8851	12157	14866
2. Commercial banks credit	1361	1334	1533	2136	2555	3058	3947	4477	5243	6697	9290	10933
3. Non-banks credit				274	261	487	745	783	1107	1429	1790	2460
4. Central Bank Credit	72	89	77	172	282	312	376	762	1012	725	1077	1473
5. Total deposits by the Financial System	1874	2117	2798	3877	3966	4375	5614	6274	7665	9363	14867	15909
6. Commercial banks deposits	1701	1830	2166	2768	3014	3372	4319	4684	5523	6860	10175	11684
7. Non-banks deposits			288	288	442	478	677	818	1254	1430	2107	2828
8. Deposits with Central Bank	173	288	632	821	510	525	618	772	888	1073	2585	1397
9. Total Treasury bill holdings*			40	60	80	520	520	514	800	1050	1500	1300
10. Holdings of C&SFC Paper	—	—	—	—	—	—	—	—	—	—	—	—

* Outstanding

	1979	1980	1981	1982	1983	1984	1985	1986
1. Total credit by the Financial System	16,855	20,321	25,568	32,710	35,118	40,290	46,722	56,881
2. Commercial banks credit	12,568	13,567	15,411	17,334	18,915	21,537	23,289	29,765
3. Non-banks credit	3,007	4,402	5,670	7,346	8,744	12,176	14,995	16,106
4. Central Bank Credit	1,280	2,351	4,484	8,030	6,459	6,577	8,434	11,010
5. Total deposits by the Financial System	19,921	21,021	23,806	30,831	34,176	40,379	46,666	55,302
6. Commercial banks deposits	13,089	13,463	15,203	17,476	18,533	21,048	23,149	29,396
7. Non-banks deposits	3,733	4,853	5,892	7,176	8,672	12,154	14,034	16,116
8. Deposits with Central Bank	2,899	2,705	2,911	6,179	6,971	7,177	9,483	9,792
9. Total Treasury bill holdings	1,781	1,310	5,552	2,920	5,029	7,639	9,681	13,350
10. Total holdings of C&SFC	—	—	124	515	732	599	687	1,140

Source: Central Bank of Kenya

Table 6
DISTRIBUTION OF COMMERCIAL BANK CREDIT TO THE PRIVATE SECTOR

	(shs m)													
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Agriculture	356	481	737	813	1088	1450	1800	2047	2211	2258	2770	2729	2968	2942
Manufacturing	558	796	839	924	1226	1848	2125	2566	3187	3501	3542	3607	4403	4792
Trade	813	1179	1087	1135	1526	1963	2015	2387	2566	2822	2884	4136	4625	5585
Exports	240	354	303	315	349	368	489	490	595	617	753	981	1033	1281
Imports	188	303	266	290	338	605	467	648	563	708	512	792	1101	1378
Domestic	385	522	519	531	839	989	1059	1248	1409	1497	1618	2362	2491	2926
Building & Construction	159	294	217	297	342	469	720	724	678	858	848	1036	1174	1147
Transport & Communication	73	140	143	179	269	389	474	565	686	660	539	549	726	942
Financial Institutions	236	138	128	201	419	336	699	326	237	598	1078	833	1115	1370
Real Estate	—	—	217	234	325	387	401	465	526	573	580	516	494	631
Private Households	391	379	439	557	732	940	690	727	916	699	825	729	924	1379
Others	415	590	577	749	1044	1294	1486	2069	1845	2103	2015	2809	3692	3966
Total	3001	3997	4384	5089	6771	9076	10410	11876	12852	14072	15081	16944	19413	22684

Source: Central Bank of Kenya

Table 7
DISTRIBUTION OF NON-BANK CREDIT TO THE PRIVATE SECTOR

	(shs m)													
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Agriculture	43	32	78	96	121	119	137	163	311	780	1012	1175	1478	1241
Manufacturing	36	40	69	119	154	313	365	540	620	823	1008	1329	1446	1659
Trade	64	61	124	182	248	473	400	634	804	1111	1247	1767	2060	1990
Exports	10	3	13	19	19	11	26	31	31	47	95	160	145	110
Imports	25	10	38	53	80	89	100	114	110	173	115	149	105	124
Domestic	29	48	73	110	149	373	274	489	663	891	1037	1458	1810	1756
Building & Construction	51	53	26	189	255	149	288	430	686	724	696	927	1199	884
Housing	248	343	426	388	421	721	821	1415	1707	2064	2332	2603	2944	3721
Other enterprises	137	166	159	199	233	211	456	627	747	943	1379	2075	2665	2730
Personal	111	137	194	247	351	420	467	327	333	263	296	448	498	631
Total	690	831	1073	1398	1772	2406	2935	4136	5209	6710	7978	10324	12290	12856

Source: Central Bank of Kenya

information on the distribution of non-bank financial institutions credit to various sectors of the economy. The dynamic role played by non-bank financial institutions in the economy is also reflected in the employment opportunities generated by its activities. While non-bank financial institutions' contribution to wage employment in the financial system was only 9 per cent in 1973, their contribution jumped to 29.3 per cent by 1985⁴.

4. Developments in Financial Intermediation, Asset Portfolio Composition and Liquidity

Table 8 shows Kenya's indices of financial intermediation calculated using the relationship between the money supply and gross domestic product (GDP). Using the money supply defined as M_2^5 , in Table 8 (column 2), the index of financial intermediation and financial deepening levelled-out between 1970 and 1986, implying that financial intermediation and deepening did not take place. However, using money supply defined as M_3^6 , the index declined for part of a period in 1970's and accelerated sharply in the 1980's. The use of money supply defined as M_3 provides evidence of increased financial intermediation.

Table 9 presents a breakdown of the asset portfolio composition of the financial system. The data shown in the table indicate that the private sector received about 60 per cent of the resources mobilized by the financial system between 1973 and 1983. The share of private sector credit to total domestic credit by banks was 80.8 and 56.2 per cent in 1973 and 1986 respectively. Looking at the table, one finds that the commercial banks allocated a greater share of their resources to four areas in the private sector, namely, agriculture, manufacturing, trade and building and construction. The share of these four enterprises to total private sector credit by the commercial banks increased from 62.9

4. Wage employment statistics for the financial system are obtained from the *Statistical Abstracts* published by the Central Bureau of Statistics, Nairobi.

5. Money Supply, M_2 , is defined as the sum of narrow money (M_1) and quasi-money. M_1 is defined as currency outside banks plus demand deposits. Quasi-money is composed of time and Savings deposits. All deposits included in the Money Supply are held with banks by the private and public sectors other than central government and non-residents.

6. Money Supply, M_3 , is defined as sum of broad money (M_2) and deposits of non-banks and Post Office Savings Bank.

Deposits of non-banks held with banks are excluded from M_2 .

Table 8
INDICES OF FINANCIAL INTERMEDIATION

	$M_2/GDP = IFI_1$	$M_3/GDP = IFI_2$	$IFI_2 - IFI_1$
1970	0.284	0.305	0.021
1971	0.286	0.311	0.025
1972	0.298	0.334	0.036
1973	0.208	0.228	0.020
1974	0.129	0.144	0.015
1975	0.146	0.166	0.020
1976	0.169	0.193	0.024
1977	0.227	0.257	0.030
1978	0.237	0.270	0.033
1979	0.265	0.309	0.044
1980	0.248	0.312	0.064
1981	0.271	0.344	0.073
1982	0.313	0.402	0.089
1983	0.302	0.406	0.104
1984	0.302	0.430	0.128
1985	0.292	0.432	0.140
1986	0.337	0.473	0.136

Source: Central Bank of Kenya

per cent in 1973 to 63.8 per cent in 1986. Table 9 also shows the distribution of credit by the non-bank financial institutions to the private sector. The share of credit by these institutions to agriculture, manufacturing, trade and housing increased from 56.7 per cent in 1973 to 67.0 per cent in 1986, with housing receiving 35.9 per cent share of this credit in 1973 and 28.9 per cent in 1986.

Table 10 shows the liquidity of the financial system, expressed as a ratio of liquid assets to total deposit liabilities. The liquidity ratio increased from 18.7 per cent in 1974 to 31.5 per cent in 1986 providing evidence that the commercial banks and the non-bank financial institutions, taken together, did not drain the solvency of the system during the years 1974 and 1986.

5. Findings and Prospects

The analysis in this paper has shown the positive effects Kenya's financial system has had on growth and the development process of Kenya since independence. Broadly speaking, there has been a rapid increase in monetization of the economy reflected in a strong growth in the ratio of money supply to gross national product. There has

Table 9
SECTORAL DISTRIBUTION OF THE FINANCIAL SYSTEM CREDIT

(shs m)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
A Banking System														
Domestic Credit	3,890	4,966	6,223	7,369	9,097	12,287	13,848	15,706	19,668	25,344	25,374	27,777	35,380	40,361
Central government (net)	509	921	1,550	1,782	1,647	2,930	3,143	3,451	6,178	9,988	8,140	8,720	9,570	14,887
Other public sector	238	231	378	685	942	456	931	498	465	999	1,854	2,113	2,397	2,769
Private sector	3,143	3,814	4,345	4,892	6,513	8,901	9,774	11,757	13,025	14,357	15,380	16,944	19,413	22,684
B Non-banks														
Total credit	709	853	1,107	1,429	1,790	2,460	3,007	4,347	5,617	7,346	9,736	12,176	14,995	16,106
Central govt (net)	—	2	—	3	5	40	33	176	372	580	1,678	1,782	2,633	3,097
Other public sector	19	20	—	14	—	14	38	35	36	56	80	70	72	153
Private sector	690	831	1,703	1,398	1,772	2,406	2,936	4,136	5,209	6,710	7,978	10,324	12,290	12,856

Source: Central Bank of Kenya

Table 10

LIQUIDITY OF THE FINANCIAL SYSTEM

	Commercial Banks	Non-banks	Overall Financial System
1974	18.6	18.9	18.7
1975	18.2	25.8	19.6
1976	24.6	16.6	23.2
1977	28.4	18.9	26.8
1978	21.5	24.3	22.1
1979	22.5	29.9	23.8
1980	16.4	24.7	18.6
1981	18.2	20.3	18.8
1982	24.4	24.0	24.3
1983	18.4	33.7	23.3
1984	22.1	37.5	27.7
1985	19.5	31.0	23.8
1986	28.1	37.7	31.5

Source: Central Bank of Kenya

also been increased financial intermediation shown by a decline in the proportion of money supply accounted for by the currency issue⁷.

Since the early 1980's there has been a considerable diversification of the financial system, reflected particularly in the rapid growth of the number of institution. Both commercial banks and non-bank financial institutions, domestic and foreign, have experienced a significant improvement in mobilizing savings and directing larger volume of credit to sectors which most effectively promote the social and economic development of the country. Considerable progress has also been achieved in branch penetration of both the banks and the non-bank financial institutions particularly into the rural areas, and in broadening the range of financial services.

The institution building aspects of Kenya's financial system and the high degree of depth it has achieved have given Kenya financial sophistication unequalled by countries in its stage of development. The pace of change which Kenya has achieved notably in the growing size, penetration, sophistication, and diversity of the financial system, imply a need for the continuation of efforts to ensure that the system continues to make the best possible contribution to growth and development of the economy. The challenge

7. The ratio of currency issue to money supply declined from 20.7 per cent in 1967 to 18.7 per cent in 1986.

for Kenya now is to build on past experience and develop the system further in a way which ensures that as the economy grows, its financial system will continue to prosper.

As time progresses, leaders in the financial system will find it useful to draw lessons from various countries and to give guidance on how to improve further the efficiency of the financial intermediation process. In this context, it will be necessary to give attention to financial market aspects as the development of these has not matched the corresponding successes achieved in other areas of the system. An important consideration to bear in mind will be the need to adopt management techniques aimed at promoting allocative efficiency of the system by pursuing policies that help to deepen financial markets⁸.

Recently, Kenya has taken steps aimed at deepening financial markets by facilitating the climate for mobilizing domestic savings through more active primary and secondary markets for government and private debt securities and also for equity securities. One important step taken was the introduction of positive real interest rates for most types of financial transactions around 1982⁹. Steps were also taken in 1986 and 1987 to broaden the spectrum of financial instruments, lengthen the average maturity of government securities and thus to diversify institutional investments.¹⁰

Although these efforts by the Government of Kenya and the Central Bank are a good starting point for the establishment of a more efficient, viable and deepened financial structure, there has been limited discussion and debate on the variety and scope of financial instruments and types of financial services that need to be undertaken in order to stimulate the development of a fully efficient financial system.

The time has now come for participants in both banks and financial institutions to begin the process of identifying areas in money and capital markets where developments are rudimentary and fragmented and where a lot more effort is required to broaden the scope for transfer of funds from cash surplus units to those that need them at the lowest possible

8. A deepening of financial markets would be associated with maintenance of positive real interest rates, a lengthening of maturities of debt instruments, broadening of markets for risk capital and extension of more credit to economic enterprises in rural areas.

9. Positive real interest rates attract savings from informal and curb markets to the formal financial system. They also ensure a more rational allocation and efficient utilization of credit.

10. An excellent discussion of Government policies on the development of money and capital markets is found in *Sessional Paper No. 1 of 1986*. The measures taken to promote the development of money and capital markets are indicated in *Central Bank of Kenya: Annual Reports 1986 and 1987*.

intermediation costs. Such development will simultaneously be of benefit to the banks and the financial institutions themselves; to their customers; and thus to the overall development of Kenya. The areas and activities which have the potential for exploitation include dealing in securities; underwriting issues; acceptance endorsement of bills of exchange; utilization of certificates of deposits; discounting of commercial papers; merchant banking and futures market for commodities and financial instruments.

In underwriting, the banks and financial institutions could choose from a number of different types of underwriting agreement. They could opt for a "firm agreement" that requires the underwriter to buy and resell all securities in question, his profit depending on the margin between his buying and selling price; or a "stand-by" agreement that requires the underwriter to take up only a residual amount of securities not already sold through other channels. They could opt also for a "best effort" agreement whereby the underwriter sells whatever he or she can of the issues on a commission basis. In many instances underwriting obligations and risks can be shared among underwriters forming an "underwriting syndicate" — a kind of insurance and a valuable asset to upcoming underwriters.

Banks and financial institutions may also seek to utilize bearer negotiable certificates of deposits or promissory notes as new forms of funding. These are fixed deposits from the point of view of the financial institutions who issue them, but they have a measure of liquidity not possessed by an ordinary fixed deposit because the certificates of deposit may be sold for cash before maturity to another holder. Thus, they may be more attractive to some depositors than conventional deposits. Acceptance or endorsement of certain categories of bills of exchange is another area with potential. The essence of a bill of exchange concept is that it is essentially an instruction given by one person to another to pay a certain sum of money, at a fixed or determinable future time. Such bills, particularly when they have the "name" of a reputable financial institution on them, can be bought and sold freely in the market.

Discounting of commercial papers is another area but before this is realised the monetary authorities would first consider allowing creditworthy banks and non-bank financial corporations to start issuing commercial paper as short-term promissory notes sold by large business at a discount to dealers, institutional investors and other corporations. These notes could be either bank guaranteed or without guarantee, and they could also be classified as dealer paper if sold by borrower to dealers who in turn sell them to investors, or directly placed paper if sold directly by the borrower to the dealer. Detailed criteria governing eligibility, financial disclosure and borrowing limits would, however,

need to be developed before commercial papers are introduced.

Merchant banking is an area that can be exploited. While merchant banks typically engage in underwriting and money market operations, they can also engage in other securities activities such as acting as a securities dealer; providing investment advice; researching companies whose securities are traded in the market; advising on mergers and acquisition; managing and investing customers' funds; mobilising venture capital; and sometimes sponsoring and managing a mutual fund. In many countries a merchant bank is also a deposit-taker and lender, like banks, but the additional securities market activities are generally what distinguishes merchant banks from commercial banks.

The future market, which is not actively utilized in Kenya, is a facility where individuals or companies can buy or sell contracts for financial instruments for delivery at a pre-determined time in the future, at a price agreed upon today. Although strong demand for this type of facility is not apparent today, banks and financial institutions could still give attention and some thought to this as the potential for futures markets can be expected to grow as the financial system develops. Another area with potential is in mutual funds which can also be classified as investment companies. The major advantage of mutual funds is that they enable people with relatively small amounts to invest and to effectively combine forces to opt the best return from securities market investments. Unlike banks, the value of their claims is not fixed but fluctuates in value with changes in the market value of the asset portfolio.

By venturing into the above more or less unexplored areas, Kenya's banks and financial institutions would provide additional investment alternatives and this could result in higher levels of savings and business. Banks and financial institutions could also look into other areas where credit is scarce. The potential for diversifying into the new areas of business and activities is there, and it is up to the banks and financial institutions to take up the challenge. While the potential for development and growth of financial markets is enormous, banks and financial institutions must also demonstrate a willingness to be imaginative and resourceful if the potential is to be exploited fully for the benefit of Kenya's future growth and development.

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Abstract

This paper analyses the development of Kenya's financial system. The analysis is focused mainly on the commercial banks and the non-bank financial institutions which are licenced under the Kenya Banking Act. It is shown in the paper that the financial system in Kenya has expanded rapidly since independence and performed efficiently over time, thereby contributing significantly towards the development of Kenya. It is also shown that the non-bank financial institutions have expanded their savings mobilization and developmental role in recent years; while performing efficiently enough to compete successfully with the commercial banks. The rapid growth in deposits and credit by the non-bank financial institutions contrasts sharply with that of the commercial banks, although performance of the latter relative to the former has been exemplary in terms of extending banking services into remote rural areas of the country.

EVOLUTION, STRUCTURE ET RESULTATS DU SYSTEME FINANCIER AU KENYA

RESUME

Cet article analyse le développement du système financier du Kenya. L'analyse est centrée en grande partie sur les activités des banques commerciales et des autres institutions financières non bancaires que le Kenya Banking Act a autorisé. On a pu démontrer que le système financier du Kenya s'est élargi rapidement après l'indépendance et que ses résultats ont été excellents depuis la période examinée. Le processus de développement du Kenya a pu ainsi être favorisé.

On a pu aussi démontrer que les institutions financières non bancaires ont accru leur rôle de développement et de mobilisation de l'épargne ces dernières années. En même temps elles ont enregistré des résultats satisfaisants de façon à résister avec succès à la pression concurrentielle des banques commerciales.

La croissance des dépôts et des prêts des institutions financières non bancaires a été bien plus rapide que dans l'expérience des banques commerciales. Toutefois les banques commerciales ont eu des performances bien meilleures en ce qui concerne l'expansion des services bancaires dans les zones rurales les plus éloignées des grandes villes.